

## Internal Revenue Service

Department of the Treasury  
Washington, DC 20224

Number: **201319003**

Release Date: 5/10/2013

Index Number: 851.02-00

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:FIP:02

PLR-122381-12

Date:

January 30, 2013

### Legend

Fund =

Trust =

State =

Adviser =

Exchange =

Index A =

Index B =

Index C =

Date 1 =

v =

w

x =

y =

Dear               :

This is in response to your letter dated May 18, 2012, and supplemental submissions dated September 5, 2012, and January 16, 2013, requesting a ruling that income and gains earned by Fund on futures contracts on Index A, including gains recognized on their termination or disposition or deemed disposition pursuant to section 1256 of the Internal Revenue Code (the "Code"), will constitute other income derived with respect to the Fund's business of investing in stock, securities, or currencies, and therefore will constitute qualifying income under section 851(b)(2).

### FACTS

Fund is an actively managed exchange-traded fund. Fund will be a non-diversified series of Trust. Trust is an open-end management investment company registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., as amended (the "1940 Act"). Trust is organized as a State statutory trust. Fund is treated as a separate corporation under section 851(g)(1). Fund intends to file an election to be taxed as a regulated investment company (RIC) under subchapter M, part 1, of the Code.

Fund's investment objective is to achieve broad equity exposure while reducing risk of broad price movements in the equity market. Its strategy is to closely track the performance of Index C. To achieve this end, Fund will allocate its assets among the following: (1) equity securities (as defined in section 2(a)(36) of the 1940 Act) of issuers contained in Index B, (2) futures contracts on Index B, (3) futures contracts on Index A, and (4) money market instruments (including repurchase agreements), as well as cash and cash equivalents, in order to collateralize its derivative investments or for other purposes.

Investments in Index B will provide Fund with broad equity exposure. Fund's investment in equity securities of issuers contained in Index B will constitute (subject to the stop loss feature, described below) at least y% of the value of Fund's total assets. Fund also invests in futures contracts on Index B as an additional method of achieving exposure to issuers contained in Index B.

To reduce the risks caused by market volatility, Fund will invest in Index A, which captures implied volatility. Implied volatility is a measure of the expected volatility of Index B that is reflected in the value of Index A. Implied volatility can act as a hedge to investments in securities contained in Index B because volatility has historically tended to correlate negatively to the performance of the U.S. equity markets.

Index A is a benchmark index designed to measure the implied market price volatility in large capitalization U.S. stocks over a thirty-day period. Index A is calculated by averaging the weighted prices of certain put and call options on Index B.

Index A historically has had a significant negative correlation to Index B. Negative correlation means that the values of Index A and Index B move in opposite directions. Since 2004, when trading in futures contracts on Index A first began, the correlation of Index A to Index B has been at least negative y%.

Because Index A cannot be traded directly, investment in Index A is accomplished by investing in cash-settled futures contracts based on Index A. Futures contracts on Index A provide investors the ability to invest in forward market volatility based on their view of the future direction or movement of Index A. Futures contracts on Index A are priced in accordance with investors' collective expectations as to future movements of Index A (which in turn reflects expected movements in Index B), not on the estimate or opinion of any particular investment banker, pricing service, or other institution. A futures contract on Index A is a standard futures contract that settles in cash based on the difference between the values of Index A at the contract's inception and expiration.

Fund represents that the value of its investments in futures contracts on Index A will not exceed an amount reasonably calculated to reduce Fund's level of risk with respect to its investment in securities of issuers included within Index B and its investments in futures contracts on Index B. Fund represents that this amount may be quantified as follows: the value of Fund's investments in futures contracts on Index A generally will not exceed the product of (a) the reciprocal of the absolute value of the percentage correlation of Index A and Index B (measured over a statistically significant period) (assuming such percentage correlation is negative) and (b) the sum of the value of Fund's investment in securities of issuers included within Index B and the notional value of Fund's investment in futures contracts on Index B.

Fund uses Index C as an asset allocation reference to determine the composition of its investments. Futures contracts on Index A generally will constitute between x% and y% of Index C's assets (calculated on the basis of the notional amount of the contracts), and equity securities will compose the remainder. During periods of low volatility, a greater portion of Fund's assets will be invested in equity securities of issuers contained in Index B. Conversely, during periods of increased volatility, a greater portion of Fund's assets will be invested in futures contracts on Index A and other Index A-related instruments. If losses over the preceding five business days are greater than w%, a stop-loss feature, an element of Index C's allocation strategy, will direct Fund to move its assets to cash.

#### LAW

Section 851(a) of the Code defines a RIC, in part, as a domestic corporation registered under the 1940 Act as a management company.

Section 851(b) of the Code limits the definition of a RIC to a corporation meeting certain election, gross income, and diversification requirements.

Section 851(b)(2) of the Code provides that a corporation shall not be considered a RIC for any taxable year unless it meets an income test (the “qualifying income requirement”). Under this test, at least 90 percent of its gross income must be derived from certain enumerated sources (such income is referred to as “qualifying income”).

Prior to the enactment of the Tax Reform Act of 1986 (the “1986 Act”), section 851(b)(2) of the Code identified qualifying income as “dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stocks or securities.” Section 851 did not contain its own definition of the term “securities,” but section 851(c)(5) provided that, for the purposes of section 851(b)(3) (the “asset diversification test”), “[a]ll other terms shall have the same meaning as when used” in the 1940 Act.<sup>1</sup>

The 1986 Act expanded the definition of qualifying income in a number of ways: (1) by adding an explicit cross-reference to the definition of “securities” in the 1940 Act; (2) by adding gains from the sale or other disposition of foreign currencies; and (3) by adding an “other income” provision. As so amended, section 851(b)(2) defines qualifying income, in relevant part, as –

. . . dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies. . . .

Section 2(a)(36) of the 1940 Act defines the term “security” as –

any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into

---

<sup>1</sup> Section 851(c)(5) of the Code was redesignated as section 851(c)(6) by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 331(c) (10-22-2004).

on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

### ANALYSIS

We have been asked to rule that income and gain generated by Fund’s investments in futures contracts on Index A constitute qualifying income under section 851(b)(2) as other income derived with respect to Fund’s business of investing in stock, securities, or currencies.

In analyzing whether a derivative financial instrument generates qualifying income under the “other income” clause of section 851(b)(2), we examine the strength of the relationship of the income or loss generated by the derivative to the RIC’s business of investing in stock, securities, or currencies. In conducting this analysis, we look not only to the applicable statutory text, but also consider the Congressional intent and legislative history accompanying the 1986 enactment of the other income provision as it bears on issues including the extent to which the income generated by the derivative is passive in nature and the nature of the derivative’s underlying referent.

#### Relationship of Income from Futures Contracts on Index A to the RIC’s Business of Investing in Stock, Securities, or Currencies

Income and gain from futures contracts on Index A may be other income that is qualifying income to Fund if the income and gain is derived with respect to the Fund’s business of investing in stocks, securities, or currencies. Fund has represented that at least y% of the value of its total assets will be invested in stocks of issuers contained within Index B, a stock market index. Stocks and futures on such stocks (including an index comprised of stocks) are 1940 Act securities. Fund therefore has a business of investing in stocks of issuers contained within Index B.

Fund invests in futures contracts on Index A in order to provide an implied volatility hedge to investments in Index B, consistent with an investment objective of positive total returns. According to the facts and representations submitted by Fund, Index A historically has displayed a significant negative correlation to the value of Index B. In this context, negative correlation means that the trends of Index A and Index B move in opposite directions. Thus, Fund will increase its investment in futures contracts on Index A to offset an expected decrease in the return of its equity investments, thereby benefitting when volatility is trending up. Similarly, when volatility is trending down, Fund will decrease its investment in futures contracts on Fund A and correspondingly will increase its equity investments.

Fund further represents that the value of its investments in futures contracts on Index A will not exceed an amount reasonably calculated to reduce Fund's level of risk with respect to its investment in securities of issuers included within Index B and its investments in futures contracts on Index B. Fund represents that this amount may be quantified as follows: the value of Fund's investments in futures contracts on Index A generally will not exceed the product of (a) the reciprocal of the absolute value of the percentage correlation of Index A and Index B (measured over a statistically significant period) (assuming such percentage correlation is negative) and (b) the sum of the value of Fund's investment in securities of issuers included within Index B and the notional value of Fund's investment in futures contracts on Index B. Fund thus has demonstrated a strong relationship between the income generated by its investments in futures contracts on Index A and its business of investing in stocks contained within Index B.

### Controlling Statutory Language

In amending section 851(b)(2) in 1986, Congress inserted parenthetical language into this statute that specifically enumerates gains from futures contracts (as well as gains from options and forward contracts) as a type of income that may constitute other income derived with respect to a RIC's business of investing in stock, securities, or currencies. Congress specifically noted that the Service had previously ruled favorably under section 851(b)(2) on income from futures contracts (131 Cong. Rec. 24570-71 (1985)), creating a strong inference that the statutory language should be interpreted in a manner consistent with those prior rulings.

Futures contracts on Index A are exchange-traded futures contracts based on Index B, an index that is based on the common stock prices of a collection of certain stocks. Therefore, income from futures contracts on Index A falls within a category of income which Congress intended to include as qualifying income under the other income provision if derived with respect to a RIC's business of investing in stock, securities, or currencies.

### Passive Nature of Income

The types of investments expressly permitted under the Code for RICs are passive in nature. Congress has explained that the favorable RIC tax provisions are intended for passive investment entities that do not engage in active business, and that a RIC's investments should be limited to income from stocks and securities, as opposed to other property. STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (1987), at 377. A letter by J. Roger Mentz, Acting Assistant Secretary of the Treasury (Tax Policy), explained the fundamental policy served by the qualifying income requirement:

First, income qualifying under section 851(b)(2) should be limited to income from property held for investment, as opposed to property held for sale to customers in the ordinary course of business. Second, income qualifying under section 851(b)(2) should be limited to income from stocks and securities, as opposed to other property. . . . For example, under the second limit, we would generally not treat as qualifying income gains from trading in commodities, even if the purpose of that trading is to hedge a related stock investment.

132 Cong. Rec. 4048 (1986) (remarks of Senator Armstrong, inserting letter of J. Roger Mentz, Acting Assistant Secretary of the Treasury (Tax Policy), dated February 5, 1986, to Rep. Flippo).

The trading of securities held by a RIC for investment is treated as passive in nature. Id. Here, the income and gain generated by Fund from investments in futures contracts on Index A are passive in nature and similar to those generated from investments in 1940 Act securities.

#### Underlying Referent

Futures contracts on Index A are derivative instruments whose value is derived from the performance of Index A and whose price is determined exclusively by reference to the value of Index A. The value of Index A, in turn, depends entirely on changes in the prices of options on Index B. Therefore, the price of a futures contract on Index A is tied to the values of the underlying stocks of issuers contained in Index B. Thus, the underlying referents of the futures contracts on Index A are options on stocks. Because stocks and options on stocks are specifically enumerated securities within the 1940 Act definition of the term security, the underlying referents of the futures contracts on Index A are securities.

#### CONCLUSION

We rule that income and gain derived from futures contracts on Index A constitute other income derived with respect to Fund's business of investing in securities within the meaning of section 851(b)(2) of the Code, provided that:

1. the notional value of Fund's investment in futures contracts on Index A generally will not exceed an amount reasonably calculated to reduce Fund's level of risk with respect to its investment in securities of issuers included within Index B and its investment in futures contracts on Index B;
2. the percentage correlation of Index A and Index B (measured over a statistically significant period) is negative; and

3. the notional value of Fund's investment in futures contracts on Index A generally will not exceed the product of (a) the reciprocal of the absolute value of the percentage correlation of Index A and Index B (measured over a statistically significant period) and (b) the sum of the value of Fund's investment in securities of issuers included within Index B and the notional value of Fund's investment in futures contracts on Index B.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed whether Taxpayer otherwise qualifies as a RIC under part I of subchapter M of Chapter 1 of the Code, and no opinion is expressed regarding whether gains generated by a derivative may also constitute qualifying income under section 851(b)(2) as gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the 1940 Act).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Susan Thompson Baker  
Susan Thompson Baker  
Senior Technician Reviewer, Branch 2  
Office of Associate Chief Counsel  
(Financial Institutions & Products)